

Case Comments

The Standard of Materiality in the Context of the Proxy Rules:

TSC v. Northway

In *TSC Industries, Inc. v. Northway, Inc.*¹ the Supreme Court clarified the meaning of the term "material" in Securities Exchange Commission rule 14a-9.² This rule, promulgated by the SEC under section 14(a) of the Securities Exchange Act of 1934,³ forbids the use of materially false or misleading statements or omissions in connection with proxy solicitations. *TSC* involved omissions from a proxy statement that was issued by the defendants, TSC Industries, Inc. and National Industries, Inc., in order to gain shareholder approval of a merger between those two corporations. The Seventh Circuit had determined that the omissions were material as a matter of law, granting summary judgment to the plaintiff Northway, Inc. (a shareholder of TSC) on the issue of the defendants' liability.⁴ The Supreme Court reversed, holding that omissions from a proxy statement are material as a matter of law only when reasonable minds cannot differ in determining that a reasonable shareholder would have found the omitted facts important in deciding how to vote.

The *TSC* decision ended a recent controversy concerning the legal definition of materiality in the context of the proxy rules. The confusion over the test of materiality had been caused by the Supreme Court's careless use of dicta in two recent opinions, *Mills v. Electric*

1. 426 U.S. 438 (1976).

2. Rule 14a-9 provides in part:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

17 C.F.R. § 240.14a-9(a) (1976).

3. Section 14(a) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

Securities Exchange Act of 1934, ch. 404, § 14(a), 48 Stat. 895 (1934) (current version at 15 U.S.C. § 78n(a) (1970)). 15 U.S.C. § 781 (1970) requires registration of all securities traded on a national securities exchange and of securities traded over the counter when the issuer has total assets exceeding one million dollars and a class of equity security held by at least five hundred persons.

4. *Northway, Inc. v. TSC Indus., Inc.*, 512 F.2d 324 (7th Cir. 1975), *rev'd*, 426 U.S. 438 (1976).

*Auto-Lite Co.*⁵ and *Affiliated Ute Citizens v. United States*.⁶ The controversy centered on whether the omission or misstatement of an item of information was material if it *would* be considered important by a reasonable shareholder, or merely if it *might* be considered important by a reasonable shareholder. In *TSC* the Supreme Court determined that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote."⁷

The *TSC* Court did much more, however, than merely resolve a semantic dispute over the definition of materiality. Although the issue in *TSC* was materiality as a matter of law upon a motion for summary judgment, the Court dealt with the concept of materiality in a comprehensive and far-reaching manner. The Court distinguished the objective test of materiality from the subjective test of reliance, which had been eliminated as an element of a rule 14a-9 action by the Court's *Mills* decision. Emphasizing that materiality is a mixed question of law and fact, the Court went on to develop a three-step analysis of materiality involving three separate factual determinations.

This Case Comment will examine materiality in its relationship to reliance and to other types of causation, as that relationship was perceived by the Court in *TSC*. Furthermore, it will explain in detail the three-step factual determination that comprised the Supreme Court's test of materiality in *TSC*, under which the Court may have injected a new element into the rule 14a-9 cause of action—proof of culpable corporate behavior similar in nature to a violation of state corporation law. Finally, a policy reason for the Court's complicated approach to materiality will be advanced: to eliminate the advantage of using the federal proxy rules to attack corporate transactions that could not be successfully attacked in state court, and thus leave the regulation of internal corporate affairs to the states.

I. BACKGROUND OF RULE 14A-9

A. *Purpose and Scope of Section 14 of the Securities Exchange Act of 1934 and Rule 14a 9.*

As part of its scheme to prevent a recurrence of the huge losses to investors that took place prior to 1934, Congress enacted section 14 of the Securities Exchange Act of 1934. The purpose of the section was to allow for the operation of fair corporate suffrage.⁸ This goal

5. 396 U.S. 375 (1970).

6. 406 U.S. 128 (1972).

7. 426 U.S. at 449.

8. See *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 381 (1970); *J.I. Case Co. v. Borak*, 377 U.S. 426, 431-32 (1964); S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934); H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934). See generally Hanna & Turlingen, *Protection of the Public*

was to be attained by requiring that proxy solicitations provide each shareholder with "adequate knowledge as to the manner in which his interests are being served" and with an "explanation . . . of the real nature of the questions for which authority to cast his vote is sought."⁹

Under section 14(a) the Securities and Exchange Commission is authorized to promulgate and enforce rules governing corporate proxy solicitations. The rules promulgated by the SEC pursuant to section 14(a) set out specific information that must be disclosed in proxy statements,¹⁰ require certain material to be filed with the SEC,¹¹ and delineate management's duty to aid shareholders in their efforts to solicit proxies or to put proposals before other shareholders.¹² The most litigated issues in the area of federal proxy regulation,¹³ however, are those raised by SEC rule 14a-9(a),¹⁴ which has served as an effective source of protection to investors under the federal securities laws.¹⁵

Rule 14a-9 has, to a large extent, supplanted state regulation in the area of proxy solicitation because many procedural and remedial advantages that are unavailable under existing state securities laws are offered under the 1934 Act.¹⁶ Rule 14a-9 ostensibly regulates only the

Under the Securities Exchange Act, 21 VA. L. REV. 251 (1935); Tracy & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025 (1934).

9. S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934).

10. 17 C.F.R. §§ 240.14a-3-.14a-5 (1976).

11. 17 C.F.R. § 240.14a-6 (1976).

12. 17 C.F.R. §§ 240.14a-7-.14a-8 (1976).

13. See 2 L. LOSS, *SECURITIES REGULATION* 917 (2d ed. 1961).

14. 17 C.F.R. § 240.14a-9 (1976).

15. See H.R. DOC. NO. 672, 79th Cong., 2d Sess. 18 (1946); 2 L. LOSS, *supra* note 13, at 866.

16. See Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 997-98 (1976). Among these advantages are the following:

1) Provisions for broad venue and nationwide service of process facilitate suits brought under the Exchange Act. *Zorn v. Anderson*, 263 F. Supp. 745, 747 (S.D.N.Y. 1966); 15 U.S.C. § 78aa (1970).

2) Many states require the posting of security for expenses in a shareholder derivative action. See, e.g., N.Y. CORP. LAWS § 627 (United States Corporation Co. 1972). This obstacle is not present in the federal courts. *McClure v. Borne Chem. Co.*, 292 F.2d 824, 837 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961).

3) Either party may demand a jury trial even if the action is a derivative one. *Ross v. Bernhard*, 396 U.S. 531, 542 (1970).

4) *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) states clearly that federal courts have full power to fashion appropriate remedies in any situation in which a violation of the proxy rules has occurred. The Supreme Court instructed the lower courts to "provide such remedies as are necessary to make effective the congressional purpose" of the proxy regulations. 377 U.S. at 433. For a general discussion of the remedies granted by the courts pursuant to *Borak*, see Comment, *Private Rights and Federal Remedies: Herein of J.I. Case v. Borak*, 12 U.C.L.A. L. REV. 1150 (1965); Note, *Private Remedies Available Under Section 14(a) of the Securities Exchange Act of 1934*, 55 IOWA L. REV. 657 (1970).

The problems of concurrent state and federal jurisdiction over certain securities violations have been dealt with extensively. See, e.g., Loss, *State Law and the Proxy Rules*, 73 HARV. L. REV. 1249 (1960); Smith, *State "Blue-Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135 (1936); Note, *Problems of Parallel State and Federal Remedies*, 71 HARV. L. REV. 513 (1958); Note, *Exclusive Jurisdiction of the Federal Courts in Private Civil Actions*, 70 HARV. L. REV. 509 (1957).

accuracy of statements and the method of soliciting proxies, not the fairness of the transaction for which the proxies are solicited.¹⁷ However, the scope of the rule is unclear; it has been interpreted on a case-by-case basis in light of the policies underlying the 1934 Act, and the courts have expanded the coverage of rule 14a-9 in the course of providing relief in private actions brought under the rule. The federal regulation of proxy solicitations has been extended, some believe, to include the regulation of internal corporate affairs, an area traditionally left to the individual states.¹⁸ In a rule 14a-9 action "[t]he injury to the complainant, real or fancied, may, and usually does, include substantive matters unrelated to the proxy rule violation."¹⁹

B. *Elements of a Private Cause of Action under Rule 14a-9.*

Since *J.I. Case Co. v. Borak*, in which a private cause of action was made available under section 14(a) of the 1934 Act,²⁰ the courts have engaged in a continuing effort to define the elements that constitute a cause of action under rule 14a-9.²¹ A summary of the issues arising under the rule is as follows:²²

1. *Parties.* *Borak* made a cause of action under section 14(a) available to any corporation or individual suing individually or derivatively for injury caused by noncompliance with the proxy rules promulgated under that section.²³ Since section 14(a) refers to *any person* who solicits a proxy or allows his name to be used in a proxy

17. *Laurenzano v. Einbender*, 264 F. Supp. 356, 361 (E.D.N.Y. 1966).

18. See *McClure v. Borne Chem. Co.*, 292 F.2d 824, 834 (3d Cir.), *cert. denied*, 368 U.S. 939 (1961); Fleischer, "Federal Corporation Law": An Assessment, 78 HARV. L. REV. 1146 (1965); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964).

The inadequacy of state supervision of corporate behavior has been amply documented. See, e.g., A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 83-84, 129, 186, 216-17 (1968); Emerson & Latham, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation*, 59 YALE L.J. 635, 635-37 (1950); Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 LAW & CONTEMP. PROB. 193 (1958); Katz, *The Philosophy of Midcentury Corporation Statutes*, 23 LAW & CONTEMP. PROB. 177 (1958); Latty, *Why Are Business Corporation Laws Largely "Enabling"?* 50 CORNELL L.Q. 599 (1965).

It is believed that the ineffective state supervision of corporations and their securities triggered the federal securities laws. 1 L. LOSS, *supra* note 13, at 105-07; Comment, *The Blue Sky Laws*, 44 VA. L. REV. 713, 714-15 (1958).

19. *Demmler, Private Suits Based on Violations of the Proxy Rules*, 20 U. PITT. L. REV. 587, 591 (1959).

20. 377 U.S. 426, 430 (1964).

21. Technically, the private cause of action authorized by *Borak* arises under section 14(a) of the Exchange Act when there is a contravention of one of the rules promulgated thereunder. However, for purposes of brevity, the cause of action will be referred to here as arising under rule 14a-9.

22. For a complete discussion of the elements of a rule 14a-9 action and the issues surrounding them, see Note, *False and Misleading Proxy Statements*, 3 GA. L. REV. 162 (1968).

23. 377 U.S. at 430-31.

solicitation,²⁴ rule 14a-9 can reach a potentially unlimited class of defendants.

2. *Registration under section 12 of the Exchange Act of 1934.* No proxy solicitation is subject to the SEC proxy rules unless it is made in respect of a security required to be registered under section 12 of the 1934 Act.²⁵ Certain securities are exempt from registration under section 12 or by virtue of the rules promulgated under that section;²⁶ furthermore, certain solicitations are exempted by the proxy rules under section 14(a).²⁷

3. *Solicitation.* This term, defined in rule 14a-1,²⁸ has been interpreted very broadly. It is clear that solicitation includes more than active solicitation. Rule 14a-1 has been applied not only to management and to shareholders but also to those who participated only in a very general sense in the solicitation.²⁹ Furthermore, the rule applies to any type of communication to shareholders that is part of a plan ending in a proxy solicitation, even when the communication is not formally labelled as a solicitation of proxies.³⁰

4. *A false or misleading statement or an omission causing information in the proxy statement to be false or misleading.* The SEC has clarified what types of statements or omissions are misleading by listing in a note to rule 14a-9 certain items that may be misleading.³¹ The list is not exhaustive, however, and extensive litigation has been conducted to determine what information must be disclosed and what

24. 15 U.S.C. § 78n(a) (1970).

25. *Id.*

26. 15 U.S.C. § 78c(a)(12) (1970); 17 C.F.R. §§ 240.12a-1-.12a-6 (1976).

27. 17 C.F.R. § 240.14a-2 (1976).

28. 17 C.F.R. § 240.14a-1(f) (1976) provides:

(f) *Solicitation.* (1) The terms "solicit" and "solicitation" include:

(i) Any request for a proxy whether or not accompanied by or included in a form of proxy;

(ii) Any request to execute or not to execute, or to revoke, a proxy; or

(iii) The furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

29. *Union Pacific R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 403 (N.D. Ill. 1964); *H.L. Green Co. v. Childree*, 185 F. Supp. 95, 96 (S.D.N.Y. 1960); SEC Securities Exchange Act Release No. 34-7208 (Jan. 7, 1964), 2 FED. SEC. L. REP. (CCH) ¶ 24,106.

30. *SEC v. Okin*, 132 F.2d 784, 786 (2d Cir. 1943). *But see* *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 599-601 (5th Cir. 1974).

31. 17 C.F.R. § 240.14a-9(b) (1976) provides:

NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section:

(a) Predictions as to specific future market values, earnings, or dividends.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

form of disclosure must be used to ensure that shareholders are being afforded a complete picture of the proposal presented for their approval.³²

5. *Standard of culpability.* The Supreme Court has not indicated whether negligence or scienter is the proper standard to be applied under rule 14a-9,³³ but the recent decision in *Gerstle v. Gamble-Skogmo, Inc.* contains a careful analysis of the issue. The Second Circuit held that no fraudulent motive or reckless disregard need be proved; however, the court was careful to point out that in the situation presented the corporate defendant had been in control of the corporation that it later acquired through the use of a joint proxy statement that was found to be misleading.³⁴ Thus, the way was left open to apply a scienter requirement in a situation in which the defendants do not have such obvious control over, and interest in, the outcome of the proxy solicitation.³⁵ Other courts that have considered the standard of care required under rule 14a-9 have simply stated that negligence is enough to impose liability.³⁶

6. *Materiality.* A misleading statement or omission in a proxy statement must be material before a defendant can be held accountable under rule 14a-9.³⁷ The materiality of a statement or omission in a proxy statement refers to the effect of that statement or omission upon a "reasonable shareholder."³⁸ The element of materiality functions as a limitation on the disclosure requirements contained in the proxy rules. It is used to ensure that only necessary and relevant

32. See, e.g., *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1291-98 (2d Cir. 1973); *General Time Corp. v. Talley Indus., Inc.*, 283 F. Supp. 832, 836 (S.D.N.Y.), *aff'd*, 403 F.2d 159 (2d Cir. 1968).

33. The Supreme Court expressly declined to reach this issue in *TSC*. 426 U.S. at 444-45 n.7. However, in the same footnote it referred to its opinion in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). *Hochfelder* held that in the absence of a finding of scienter there can be no liability under rule 10b-5. *Id.* at 214. Because the Court, in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), held that there is an overlap in coverage between rules 10b-5 and 14a-9 with respect to misleading proxy statements, it would seem inconsistent to have different standards of culpability under the two rules, at least with respect to proxy solicitations. The Court's reference to *Hochfelder* in *TSC* may be an indication that the Court will require scienter as a prerequisite to liability under rule 14a-9 when it finally deals with the issue. But see *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299-1301 (2d Cir. 1973); *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 853, 861-63 (D. Del. 1972); 5 L. Loss, *supra* note 13, at 2864-65; Note, *The Proper Standard of Fault for Imposing Personal Liability on Corporate Directors for False or Misleading Statements in Proxy Solicitations Under Section 14(a) of the Securities Exchange Act of 1934 and SEC Rule 14a-9*, 34 OHIO ST. L.J. 670, 681 (1973) [hereinafter cited as Note, *Proper Standard*].

34. 478 F.2d 1281, 1300-01 (2d Cir. 1973).

35. For a suggestion that a "modified scienter" standard be adopted in the case of outside directors see Note, *Proper Standard*, *supra* note 33, at 688-90.

36. See *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 853, 858-65 (D. Del. 1972); *Berman v. Thomson*, 312 F. Supp. 1031, 1035 (N.D. Ill. 1970); *Norte & Co. v. Huffines*, 304 F. Supp. 1096, 1109 (S.D.N.Y. 1968), *aff'd*, 416 F.2d 1189 (2d Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Richland v. Crandall*, 262 F. Supp. 538, 553 n.12 (S.D.N.Y. 1967).

37. 17 C.F.R. § 240.14a-9(a) (1976).

38. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 445 (1976).

information is disclosed to shareholders in the proxy statement,³⁹ thus avoiding a situation in which "the data submitted to the stockholders would be so bulky and unwieldy . . . that it might be more confusing than useful to the stockholders."⁴⁰

The requirement of materiality also protects defendants from liability for violations so trivial that they could not possibly have caused injury.⁴¹ This protection results from the fact that materiality embodies a connection between a technical violation of the securities laws and an injury to the complainant; it is therefore closely related to causation.⁴² The element of causation is a separate requirement in a rule 14a-9 cause of action, however, and must be analyzed before the relationship between materiality and causation can be explored.

7. *Causation.* The Supreme Court dealt with this issue in *Mills v. Electric Auto-Lite Co.*,⁴³ which made clear that two different types of causation must be distinguished in analyzing a rule 14a-9 claim. In its decision in *Mills*⁴⁴ the Seventh Circuit had applied a "but for" test, requiring plaintiff to show that the corporate transaction complained of—a merger—could not have occurred if the proxy statement had not been misleading.⁴⁵ This test apparently required two types of causal connection: a causal link between the proxy statement and the shareholder's vote (subsequently referred to as vote-causation), which this court defined in terms of reliance; and a causal link between the proxy solicitation and the execution of the merger (subsequently referred to as transaction-causation).⁴⁶ The Supreme Court expressly separated these two aspects of causation in *Mills*, substituting materiality for reliance as the test of vote-causation, while maintaining the requirement of transaction-causation.⁴⁷

39. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 600 n.29 (5th Cir. 1974); Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1351-52 (1966); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 618-19 (1974).

40. *Richland v. Crandall*, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

41. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 384 (1970).

42. *Northway, Inc. v. TSC Indus., Inc.*, 512 F.2d 324, 330 (7th Cir. 1975), *rev'd*, 426 U.S. 438 (1976); Comment, *Elements of a Cause of Action Under Section 14(a) of the Securities Exchange Act of 1934: The Priorities of Proxy Regulation*, 42 TEMP. L.Q. 36, 38 (1968); Note, *False and Misleading Proxy Statements*, 3 GA. L. REV. 162, 179 n.118 (1968).

43. 396 U.S. 375 (1970).

44. 403 F.2d 429 (7th Cir. 1968), *vacated*, 396 U.S. 375 (1970).

45. *Id.* at 435-36.

46. "Vote-causation" and "transaction-causation" are used here to denote a distinction that has not been clearly made by the courts. The two phrases will be used as a shorthand method of dealing with cases in which causation was an issue, although the courts involved did not necessarily approach the issue with the dichotomy represented by these terms in mind.

47. 396 U.S. at 385. The Supreme Court expressly reserved the question of whether transaction-causation could be established when management had enough votes to consummate the desired transaction without the necessity of soliciting proxies. *Id.* at 385 n.7. Lower courts have had difficulty in dealing with this issue. In *Barnett v. Anaconda Co.*, 238 F. Supp. 766, 770-74 (S.D.N.Y. 1965), it was held that when defendants had majority voting power and minority voters could not affect the outcome of the vote, no cause of action under rule 14a-9 had arisen. *Accord*, *Robbins v. Banner Indus., Inc.*, 285 F. Supp. 758, 762-63 (S.D.N.Y. 1966);

The Court's holding in *Mills* carries an implicit recognition that the concept of materiality embodies a type of causal connection; however, materiality's distinction from reliance and from transaction-causation must be kept in mind. Transaction-causation refers to whether the successful accomplishment of the transaction for which approval was sought was actually dependent upon the outcome of the proxy solicitation. Reliance is a subjective test of vote-causation⁴⁸ and refers to whether the votes of the individual shareholders in question were decisively affected by a misleading proxy statement. The standard of materiality, on the other hand, is couched in objective language, in terms of the effect of a misleading proxy statement on a "reasonable shareholder" and deals with probabilities, not actualities.⁴⁹ Materiality may be defined as an objective test of vote-causation, as opposed to the subjective test of vote-causation represented by the element of reliance.

C. *The Need for a Clear Definition of Materiality*

As a result of the broad interpretations given the other elements of a rule 14a-9 cause of action and the elimination of the requirement of reliance in *Mills*, materiality became the last line of defense for corporations and individuals involved in litigation concerning violations of the proxy rules.⁵⁰ The need for a clear definition of materiality became pronounced. Confusion developed over the legal standard of materiality under rule 14a-9, and the *Mills* decision provided no guidance. Lower courts spent much time and energy dealing with whether an item of information was material if it *would* be considered important by a reasonable shareholder or if it *might* be considered important by a reasonable shareholder.⁵¹ The Supreme Court granted certiorari to the defendants in *TSC Industries, Inc. v. Northway, Inc.* specifically to resolve a conflict between circuits⁵² on the issue of whether materiality is determined by what a reasonable shareholder would, or merely might, find important.

Hoover v. Allen, 241 F. Supp. 213, 231-32 (S.D.N.Y. 1965). But in *Laurenzano v. Einbender*, 264 F. Supp. 356, 360-62 (E.D.N.Y. 1966), the court held that even when defendants had voting control, the omission of material facts in a proxy statement might have an effect on the voting results. See generally Note, *Causation and Liability in Private Actions for Proxy Violations*, 80 Yale L.J. 107 (1970).

48. *List v. Fashion Park, Inc.*, 340 F.2d 457, 462-63 (2d Cir.), cert. denied, 382 U.S. 811 (1965); *In Re Scientific Control Corp.*, 71 F.R.D. 491, 513 (S.D.N.Y. 1976).

49. *Gilbert v. Nixon*, 429 F.2d 348, 357 n.18 (10th Cir. 1970).

50. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973).

51. See, e.g., *Northway, Inc. v. TSC Indus., Inc.*, 512 F.2d 324, 330-32 (7th Cir. 1975) rev'd, 426 U.S. 438 (1976); *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 603-04 (5th Cir. 1974); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1301-02 (2d Cir. 1973); *Kaufman v. Lawrence*, 386 F. Supp. 12, 15 (S.D.N.Y. 1974); *Richland v. Crandall*, 262 F. Supp. 538, 553 (S.D.N.Y. 1967).

52. 426 U.S. 438, 443 (1976).

II. TSC INDUSTRIES, INC. v. NORTHWAY, INC.

A. *The Facts*

In December 1969, National Industries, Inc.⁵³ acquired TSC Industries, Inc.⁵⁴ by exchanging National "series B" preferred stock and warrants for TSC common and "series one" preferred stock.⁵⁵ Prior to the merger, National owned approximately 34% of TSC's voting securities, which had been acquired by purchases throughout 1969 from the founder and principal shareholder of TSC, Charles E. Schmidt, and from other sources. National also had five representatives on TSC's board of ten, one of whom was chairman of the TSC board (Stanley R. Yarmouth, president and chief executive officer of National), and one of whom was chairman of TSC's executive committee (Charles F. Simonelli, executive vice president of National).⁵⁶ Shareholder approval for the merger⁵⁷ was obtained by means of a joint proxy statement issued by TSC and National on November 12, 1969.

The adequacy of the proxy statement was attacked by Northway, Inc.,⁵⁸ a TSC shareholder. In a complaint filed in federal district court, Northway alleged that the proxy statement contained omissions of material facts in violation of section 14(a) and rule 14a-9.⁵⁹ Its subsequent motion for partial summary judgment on the liability issue raised the question of whether the following omissions from the joint proxy statement were material:

1) The proxy statement did not reveal that Yarmouth was the chairman of the TSC board of directors or that Simonelli was the chairman of the TSC executive committee. All other facts concerning the relationship between National and TSC were prominently disclosed in the proxy statement.⁶⁰

2) The proxy statement did not disclose that TSC and National

53. National was a Kentucky corporation with common stock and preferred stock listed on the New York Stock Exchange and warrants listed on the American Stock Exchange.

54. TSC was a Delaware corporation with common stock and preferred stock listed on the New York Stock Exchange.

55. The exchange rate was .6 share of National "series B" preferred stock and one National warrant for each share of TSC "series one" preferred stock, .5 share of National "series B" preferred stock and 1-1/2 National warrants for each share of TSC common stock. National "series B" preferred stock was convertible into .75 share of National common stock, and a National warrant entitled the holder to purchase a share of National common stock for \$21.40 until October 31, 1978.

56. All three National nominees on the TSC board who attended the meeting at which the directors' approval of the merger was obtained abstained from voting upon the merger proposal, as did one other director.

57. Delaware law requires shareholder approval of transactions of this type. DEL. CODE tit. 8, § 275 (1975).

58. Northway was a private Delaware holding company organized by an individual investor to hold his investments.

59. 426 U.S. at 438.

60. *Id.* at 452.

had stated in reports required to be filed with the SEC that National "may be deemed to be a parent of TSC as that term is defined in the Rules and Regulations under the Securities Act of 1933."⁶¹

3) The proxy statement did not disclose the contents of a letter sent to National by the investment banking firm of Hornblower & Weeks-Hemphill that valued the National warrants to be issued in the merger at \$1.75 lower than the current market value disclosed in the proxy statement. The letter from Hornblower also predicted a possible drop in the value of the warrants because of the large number of warrants to be issued in the exchange.⁶²

4) The proxy statement failed to disclose that 8.5% of the purchases of National common stock during the period between the initial purchases of TSC voting securities by National and the date of the joint proxy solicitation had been made by National and by Madison Fund, Inc. Madison was a mutual fund whose director was board chairman of National and whose president was employed by National as a consultant. Northway contended that although the exchange to TSC shareholders involved National preferred stock and warrants, the relationship between Madison and National indicated a possible collusive attempt to manipulate the price of National common stock, which may have artificially raised the market price of National preferred stock and warrants.⁶³

The district court denied Northway's motion for partial summary judgment, refusing to hold that the omissions complained of were material as a matter of law.⁶⁴ An interlocutory appeal was taken pursuant to 28 U.S.C. § 1292(b).

61. *Id.* National filed form 13D in compliance with 15 U.S.C. § 78m(d) (1970) and 17 C.F.R. § 240.13d-1 (1976). Item Four of the form requires that if the purpose of the acquisition of securities is to gain control of the business of the issuer, any plans or proposals of the acquiring party to make major changes in that business must be disclosed. In response to this requirement National indicated that it might be a "parent" of TSC. TSC filed the same information with the SEC in its forms 10-K and 8-K in compliance with 15 U.S.C. § 78n(a) (1970) and 17 C.F.R. § 240.13a-10, 11 (1976). "Parent" is defined under the Exchange Act at 17 C.F.R. § 240.12b-2(a), (f), (k) (1976) as follows:

(a) *Affiliate.* An "affiliate" of, or a person "affiliated" with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(f) *Control.* The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(k) *Parent.* A "parent" of a specified person is an affiliate controlling such person directly, or indirectly through one or more intermediaries.

62. 512 F.2d at 334-35.

63. 426 U.S. at 460-61.

64. 361 F. Supp. at 114, 117.

B. *Seventh Circuit Decision*

The Seventh Circuit reversed the district court's denial of summary judgment on the issue of liability. The court concluded that the test of materiality to be applied was whether an omitted fact was "of such a character that it might have been considered important by a reasonable shareholder who was in the process of determining how to vote."⁶⁵ Using this test, the court found all four omissions in the proxy statement material as a matter of law.

1) *The Positions of Yarmouth and Simonelli on the TSC Board and the Information Contained in the SEC Filings.* The court of appeals stated that there remained a genuine issue of fact with regard to National's control over TSC.⁶⁶ However, the court held that the omission of the positions of the National nominees on the TSC board and the omission of the information filed with the SEC by TSC and National were material regardless of whether National actually controlled TSC. The court felt that the omission of these facts was material as a matter of law because the information could have indicated to a TSC shareholder that less than best efforts had been used by the management of TSC to negotiate favorable terms for its stockholders in the merger transaction with National.⁶⁷

2) *The Hornblower Letter.* The proxy statement had emphasized an opinion letter to TSC from Hornblower that affirmed the fairness to TSC stockholders of the terms of the exchange of TSC shares for National shares.⁶⁸ The court of appeals noted that the first letter's emphasis upon a "substantial premium over current market values," when viewed in conjunction with a summary three pages later in the proxy statement of the current market values of TSC and National securities, might have led shareholders to calculate, and thus to expect, a premium substantially higher than that actually received. This miscalculation could have been avoided by inclusion in the proxy statement of the subsequent letter from Hornblower to National predicting a drop in the value of the National warrants. Therefore, in the opinion of the court, the omission from the proxy statement of the information contained in the second Hornblower letter was material as a matter of law.⁶⁹

65. 512 F.2d at 332 (quoting *Mills*, 396 U.S. at 384).

66. *Id.* at 329.

67. *Id.* at 333.

68. Page six of the proxy statement contained the following language:

In such opinion, [Hornblower] considered, among other things, the current market prices of the securities of both corporations, the high redemption price of the National Series B Preferred Stock, the dividend and debt service requirements of both corporations, the substantial premium over current market values represented by the securities being offered to TSC stockholders and the increased dividend income.

512 F.2d at 334 n.16.

69. 512 F.2d at 335.

3) *Purchases by National and Madison of National Common Stock.* The Seventh Circuit's reasoning concerning this omission was analogous to its reasoning on the control issue. Although collusion between National and Madison could not be assumed for purposes of summary judgment, the omitted information with regard to the purchases was material as a matter of law because its inclusion might have led stockholders to perceive the possibility of market manipulation, thereby affecting their judgment of the value of the proposed exchange.⁷⁰

The Seventh Circuit reached its conclusion that all four omissions in the proxy statement were material by defining "materiality" to include information misstated in or omitted from a proxy statement that might be *relevant* to a reasonable shareholder's voting decision.⁷¹ The court had accurately concluded that the "would" standard of materiality was a test of something more than relevancy, that it was a means of determining vote-causation.⁷² Interpreting the Supreme Court's decision in *Mills* to mean that vote-causation was no longer an element of a rule 14a-9 cause of action, the Seventh Circuit believed that use of the "would" standard was precluded: "[A]ny test of materiality which requires a finding of some probability that the omitted fact would affect the voting process necessitates the same difficult proofs the Supreme Court sought to avoid by eliminating the need for independent proof of causation or reliance."⁷³ The court was unable to distinguish the subjective test of vote-causation (reliance) eliminated in *Mills* from the objective test of vote-causation represented by the "would" standard of materiality.⁷⁴ The court believed both tests of vote-causation were precluded by *Mills*. Therefore it applied the "might" standard of materiality to determine whether any of the information omitted from the proxy statement of TSC and National might have been relevant to a reasonable shareholder's decision.⁷⁵ It was this approach to materiality that concerned the Supreme Court.

III. THE SUPREME COURT DECISION

A. *The Proper Standard of Materiality*

The Court characterized the materiality standard applied by the Seventh Circuit as "too suggestive of mere possibility, however unlikely,"⁷⁶ and set forth the following as the proper standard of

70. *Id.* at 336.

71. *Id.* at 331 n.13.

72. *Id.* at 331.

73. *Id.*

74. See text accompanying notes 43-49 *supra*.

75. 512 F.2d at 331 n.13.

76. 426 U.S. at 449 (quoting *Gerstle*, 478 F.2d at 1302).

materiality: "[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."⁷⁷ The Seventh Circuit had interpreted *Mills* as precluding the consideration of vote-causation in a 14a-9 action.⁷⁸ The *TSC* Court corrected this erroneous interpretation of *Mills* by emphasizing that the *Mills* case had eliminated only the *subjective* test of reliance, *i.e.*, proof that a defect in a proxy statement had actually affected the outcome of the shareholder vote.⁷⁹ The Court noted that the "would" test of materiality is an objective test of vote-causation involving the reactions of a hypothetical "reasonable investor" to misstatements or omissions in a proxy statement.⁸⁰ Therefore, the Court indicated, proof of materiality by means of the "would" standard does not contravene the holding in *Mills*.⁸¹

TSC makes clear that the materiality of a misstatement or omission in a proxy statement must be proved by showing the probable causative effect of the defect upon a reasonable shareholder, not by showing the mere relevancy of a defect to a reasonable shareholder's decision. After *TSC* and *Mills*, therefore, a plaintiff in a rule 14a-9 action must prove a causal connection between the proxy solicitation and the transaction for which approval was sought (transaction-causation), and that a reasonable shareholder would have found the alleged defect in the proxy statement important (materiality or objective vote-causation).

B. *The Court's Treatment of Mills and Affiliated Ute*

The Supreme Court was indirectly responsible for the broad standard of materiality used by the Seventh Circuit. Language contained in two prior opinions of the Court had caused considerable confusion among the lower courts concerning the proper test. In *TSC* the Court's first task was to resolve the conflicts caused by *Mills* and by *Affiliated Ute Citizens v. United States*.⁸²

The language with which the Supreme Court, in *Mills*, had eliminated the element of reliance in a rule 14a-9 cause of action created confusion concerning the definition of materiality.

Where the misstatement or omission in a proxy statement has been shown to be "material," as it was found to be here, that determination itself indubitably embodies a conclusion that the defect was of such a character that it *might have been considered important* by a reasonable shareholder who was in the process of deciding how to vote. This

77. 426 U.S. at 449.

78. See text accompanying notes 71-75 *supra*.

79. 426 U.S. at 446-47.

80. *Id.* at 445.

81. *Id.* at 447.

82. 406 U.S. 128 (1972).

requirement that the defect have a significant *propensity* to affect the voting process is found in the express terms of Rule 14a-9, and it adequately serves the purpose of ensuring that a cause of action cannot be established by proof of a defect so trivial, or so unrelated to the transaction for which approval is sought, that correction of the defect or imposition of liability would not further the interests protected by § 14(a).⁸³

The Seventh Circuit had also decided the *Mills* case and had found certain omissions in a merger proxy statement to be material as a matter of law.⁸⁴ The facts omitted in the proxy statement were that the acquiring company, Mergenthaler Linotype Company, had nominated all eleven directors of the acquired company, Electric Auto-Lite, and controlled the operations of that company.⁸⁵ Other facts concerning the relationship between Mergenthaler and Electric Auto-Lite had been disclosed in the proxy statement. But the statement emphasized that the board of directors of Electric Auto-Lite had recommended the merger, and the Seventh Circuit concluded that equal emphasis should have been given to the lack of autonomy of that board. The court reached this conclusion without articulating the standard of materiality it was applying.⁸⁶

The Supreme Court specifically declined to review the Seventh Circuit's determination of materiality in *Mills*.⁸⁷ And yet the Court accepted the finding of materiality by the court of appeals for the purpose of dealing with the issue of causation,⁸⁸ describing that finding as embodying a conclusion that a reasonable shareholder *might have considered* the omissions important. Thus, it is no surprise that the *Mills* case, in which the omissions from the proxy statement were very similar to those in *TSC*, was relied upon by the Seventh Circuit in deciding *TSC*.

In *TSC* the Supreme Court was quick to point out that the Seventh Circuit's reliance on *Mills* was misplaced because *Mills* dealt solely with reliance.⁸⁹ The Court further noted that the words suggesting a "general notion of materiality" in *Mills* were those containing a "reference to materiality as a 'requirement that the defect have a significant *propensity* to affect the voting process.'"⁹⁰ The Court could also have distinguished *TSC* from *Mills* on its facts, because control was a proven fact in *Mills*, known conclusively by the defendants when

83. 396 U.S. at 384 (emphasis added).

84. *Mills v. Elec. Auto-Lite Co.*, 403 F.2d 429, 435 (7th Cir. 1968), *vacated*, 396 U.S. 375 (1970).

85. 396 U.S. at 378.

86. 403 F.2d at 433-35.

87. 396 U.S. at 381 n.4.

88. *Id.* at 384.

89. 426 U.S. at 446-47.

90. *Id.* at 447. The Court was referring to the voting process of an individual shareholder, not to the outcome of a shareholder election.

they issued their joint proxy statement.⁹¹ However, the Seventh Circuit was unable to perceive these differences, and it was the *Mills* decision which caused that court's confusion over the standard of materiality to be applied in *TSC*.

The confusion was compounded by the Supreme Court's decision in *Affiliated Ute Citizens v. United States*. In *Affiliated Ute* the Court dealt with the issue of reliance under rule 10b-5, eliminating that requirement as it had under rule 14a-9 in *Mills*.⁹² In its opinion the Court used language similar to that carelessly used in *Mills*: "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."⁹³ In *TSC* the Court deprecated the Seventh Circuit's reliance on this decision as well:

The conclusion embodied in the quoted language was simply that positive proof of reliance is unnecessary when materiality is established, and in order to reach that conclusion it was not necessary to articulate a precise definition of materiality, but only to give a "sense" of the notion. The quoted language did not purport to do more.⁹⁴

With hindsight, then, the Court clarified its misleading language, but in the period between 1970, when *Mills* was decided, and 1976, when *TSC* was decided, the meaning of materiality was disputed in the lower courts, and this dispute was not limited to rule 14a-9 cases.⁹⁵ The confusion of the courts was well summarized in *Feit v. Leasco Data Processing Equipment Corp.*:

Some probability that the investor's decision would be affected by a disclosure is a prerequisite to a finding of materiality. The degree of probability that it would have such an impact has been differently stated by the courts. They have focused on the effect on the reasonable purchaser, variously asking whether he "might" or "would" or "might well have been" affected by the information; they have asked whether it is "reasonably certain" that the information would have had a "substantial effect" or whether it "might" have had a "significant propensity" to affect him.⁹⁶

91. 403 F.2d at 433-34.

92. 406 U.S. 128, 153-54 (1972).

93. *Id.*

94. 426 U.S. at 447 n.9.

95. See, e.g., *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846, 851 (3d Cir. 1973) (15 U.S.C. § 78n(e) (1970)); *Sonesta Int'l Hotels Corp. v. Wellington Assocs.*, 483 F.2d 247, 251 (2d Cir. 1973) (15 U.S.C. § 78n(e) (1970)); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-1301 (2d Cir. 1973) (rule 14a-9); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 269 (3d Cir. 1972) (rule 10b-5); *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1171 (2d Cir. 1970) (rule 10b-5); *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812, 827-28 (D. Del. 1974) (rules 14a-9 & 10b-5); *Puma v. Marriott*, 363 F. Supp. 750, 757 (D. Del. 1973) (rules 14a-9 and 10b-5); *First Sur. Corp. v. Community Bank*, 337 F. Supp. 667, 669-70 (C.D. Cal. 1971) (rule 14a-9); *Beatty v. Bright*, 318 F. Supp. 169, 173 (S.D. Iowa 1970) (rule 14a-9); *Colonial Realty Corp. v. Baldwin-Montrose Chem. Co.*, 312 F. Supp. 1296, 1299 (E.D. Pa. 1970) (rules 14a-9 & 10b-5).

96. 332 F. Supp. 544, 569 (E.D.N.Y. 1971).

The Supreme Court resolved the dilemma in *TSC*, opting for the "would" standard of materiality.

C. *The Court's Application of the "Would" Standard:
The Three-Step Determination of Materiality*

Early in the *TSC* opinion the Court set out a theoretical framework for determining the materiality of a misstatement or omission in a proxy statement under the "would" standard.⁹⁷ The framework involves three levels of factual determinations. First, the facts alleged to have been misstated or omitted must be proved. The Court noted, however, that these "underlying objective facts, which will often be free from dispute, are merely the starting point for the ultimate determination of materiality";⁹⁸ the importance or materiality of these misstated or omitted facts cannot be determined without an analysis of the inferences to which these facts would reasonably lead. The second step, then, in the Court's determination of materiality is a factual determination of the inferences that would be drawn by a reasonable shareholder from the underlying objective facts alleged to be misstated or omitted in the proxy statement. The Court pointed out that the assessment of these inferences is "peculiarly . . . for the trier of fact,"⁹⁹ and that the "jury's unique competence in applying the 'reasonable man' standard"¹⁰⁰ would generally prevent the drawing of these inferences as a matter of law upon a motion for summary judgment. The third step in the Court's materiality analysis is a determination of the importance to a reasonable shareholder of the inferences that would have been drawn from the information omitted from the proxy statement. Resolution of this issue is "the ultimate determination of materiality."¹⁰¹ However, it cannot be reached until the two previous factual determinations have been made.¹⁰²

Although the Court did not reiterate its method for determining materiality in the course of discussing each of the four omissions in the proxy statement of *TSC* and *National*, its three-step analysis is implicit in its treatment of each of the issues. The Supreme Court dealt with the four omissions that had been found to be material by the Seventh Circuit as follows:

1) *Omission of Statement of Yarmouth's and Simonelli's Positions on the TSC Board.* The Seventh Circuit had found the omission of the positions of Yarmouth and Simonelli on *TSC*'s board to be material because the information could have indicated to a *TSC*

97. 426 U.S. at 450.

98. *Id.*

99. *Id.*

100. *Id.* at 450 n.12.

101. *Id.* at 450.

102. *Id.*

shareholder that National controlled TSC and that the negotiations between National and TSC concerning the merger between the two companies had been less than fair to the TSC shareholders.¹⁰³ The Supreme Court, however, noted that the proxy statement contained sufficient facts to clearly reveal the nature of the relationship between TSC and National and that the positions of Yarmouth and Simonelli on TSC's board could be viewed as "additional facts,"¹⁰⁴ not necessary to allow a reasonable shareholder to reach an informed decision.

Although the Court did not explicitly go through the three steps of the materiality analysis it had articulated earlier, the analysis may be inferred from the opinion as follows: The Court assumed that the positions of Yarmouth and Simonelli on the TSC board, the underlying objective facts alleged to be omitted from the proxy statement, were free from dispute. The Court was unwilling, however, to determine as a matter of law that these facts alone led to an inference of control of TSC by National. Given the extensive disclosure already contained in the proxy statement, which indicated some degree of influence by National over TSC, it was not beyond dispute that reasonable shareholders would infer the fact of control solely from the additional information concerning the positions of Yarmouth and Simonelli on TSC's board. The Court would not allow the inference of control to be made as a matter of law, and therefore the issue of the importance of the omission to a reasonable shareholder could not be reached.¹⁰⁵

2) *Omission of Information Contained in SEC Filing.* The Seventh Circuit had held that the omission of the information filed with the SEC by TSC and National was material regardless of whether National actually controlled TSC.¹⁰⁶ The Supreme Court, however, approached the issue differently, noting that a genuine issue of fact remained concerning National's control of TSC and assuming for purposes of summary judgment that National did not control TSC.¹⁰⁷ The Court believed that if the language used by TSC and National in their SEC filings had been included in the proxy statement, it would have been read by shareholders to mean that National clearly controlled TSC. This was not necessarily the meaning of the statement in the filings that "National may be deemed to be a parent of TSC," but the Court was concerned with the possibility that this language could be interpreted to mean that TSC and National acknowledged a control relationship between themselves. Assuming, then, as the Supreme Court did for purposes of summary judgment, that there was

103. See text accompanying notes 66-67 *supra*.

104. 426 U.S. at 453.

105. *Id.* at 452-53.

106. See text accompanying notes 66-67 *supra*.

107. 426 U.S. at 453.

no control, the information filed with the SEC could not have been included in the proxy statement without misleading shareholders. Indeed, if it had been included, the Court stated, a disclaimer of control or of knowledge of control would have been necessary.¹⁰⁸ Therefore, the Court concluded, "The net contribution of including the contents of the SEC filings accompanied by such disclaimers is not of such obvious significance, in view of the other facts contained in the proxy statement, that their exclusion renders the statement materially misleading as a matter of law."¹⁰⁹

Implicit in the Court's consideration of this issue is the three-level materiality analysis set out by the Court in the first part of its opinion. Under this analysis, the issue was disposed of at the second level: Although the fact that TSC and National had filed the statements with the SEC was undisputed, the Court would not draw the inference that National controlled TSC from this fact as a matter of law. That is, the Court was unwilling to hold as a matter of law that a reasonable shareholder would draw the inference of control from the information omitted from the proxy statement. Therefore, the issue of the significance of the omission to a reasonable shareholder, the third level of the materiality analysis, could not be reached upon a motion for summary judgment. On remand the trier of fact would have to determine whether the inference of control would be drawn by a reasonable shareholder before the significance of that inference could be considered.¹¹⁰

In its discussion of the omission of the information contained in the SEC filings, the Court gave an example of omissions in a proxy statement, the materiality of which could be determined as a matter of law because all three steps in the process involved factual determinations upon which reasonable minds could not differ. The Court pointed to facts suggestive of control which TSC and National *had* included in their proxy statement: National's 34% stock interest in TSC and its five nominees on TSC's board at the time of the proxy solicitation.¹¹¹ Omission of these facts would have been material as a matter of law because "even if National did not 'control' TSC, its stock ownership and position on the TSC board make it quite clear that it enjoyed some influence over TSC, which would be of obvious importance to TSC shareholders."¹¹² In other words, under the Court's systematic analysis of materiality, National's 34% stock interest and its nominees on TSC's board were undisputed facts. Although control could not be inferred as a matter of law from these facts, some degree of influence

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.* at 453-54 n.15.

112. *Id.*

by National over TSC could be inferred as a matter of law. Furthermore, the importance to a reasonable shareholder of this influence would be obvious and could therefore be determined as a matter of law.

3) *Hornblower Letter*. The Court described the issue regarding this omission as

whether the advice given . . . in the subsequent Hornblower letter—that there may be a decline in the market price of the National Warrants—had to be disclosed in order to clarify the import of the proxy statement's reference to "the substantial premium over current market values represented by the securities being offered to TSC stockholders."¹¹³

The Court did not discuss the materiality of the omission of the lower valuation of the National warrants contained in the Hornblower letter because an issue of fact remained to be resolved prior to the application of the three-step determination of materiality—whether the omission of the information in the Hornblower letter was *misleading*.¹¹⁴ Stated more precisely in terms of rule 14a-9,¹¹⁵ the factual issue to be resolved was whether the omission in the proxy statement caused other statements contained therein to be misleading.

The Court focused upon the two parts of the proxy statement that could possibly have been misleading as a result of the omission. The first was the reference in the proxy statement to the "substantial premium to be received by the TSC shareholders." The Court stated that this language referring to a "substantial premium" was not misleading as a matter of law because the premium received by the TSC shareholders for their TSC shares may have been "substantial" despite the lower valuation of the National warrants that appeared in the Hornblower letter.¹¹⁶ The second part of the proxy statement that could have been misleading due to the omission of the Hornblower letter was the presentation of the current market values of the various securities involved in the merger transaction. Northway argued that this presentation may have misled shareholders to make an erroneous calculation of the expected premium. The Court, however, felt that the determination of whether a shareholder would have been led to make such a calculation in the absence of the information concerning the lower value of the National warrants should be left to the trier of fact and could not be resolved as a matter of law.¹¹⁷

Thus, in its consideration of the omission of the information in the Hornblower letter, the Court made clear that the issue of whether a misstatement or omission in a proxy statement was misleading is

113. *Id.* at 458.

114. *Id.* at 459-60.

115. See 17 C.F.R. § 240.14a-9(a) (1976).

116. 462 U.S. at 458-59.

117. *Id.* at 459-60.

a separate issue of fact that must be resolved before the three-step factual determination of materiality can be reached.¹¹⁸ The Supreme Court's disposition of this issue, then, does not contribute to an understanding of the analysis to be used in determining materiality.

4) *Purchases of National Common Stock by National and Madison Fund.* The Seventh Circuit had held that regardless of whether the purchases by Madison and National had actually been coordinated to support the market price of the National common stock, the omission of information concerning these purchases was material as a matter of law.¹¹⁹ The Supreme Court was concerned that the Seventh Circuit's disregard of the issue of whether there was actual market manipulation by Madison and National would lead to the imposition of "civil liability on a theory that undisclosed information may suggest the existence of market manipulation, even if the responsible corporate officials knew that there was in fact no market manipulation."¹²⁰

The Court assumed that the purchases by Madison and National were undisputed facts. However, the Court would not allow the inference of market manipulation, which had been inferred from these facts by the Seventh Circuit, to be drawn as a matter of law because no showing had been made by Northway that manipulation had actually occurred. Rather, the presence of manipulation was an issue that remained to be resolved by the trier of fact before the significance of the purchases by National and Madison to a reasonable shareholder could be considered.¹²¹

IV. CRITIQUE

A. *Apparent Inconsistencies in the Court's Analysis of Materiality*

To summarize the above analysis of the Court's opinion, the Supreme Court decided that materiality is to be determined in terms of the probable causative effect upon shareholders of a misstatement or omission in a proxy statement. Within the narrow factual situation presented to it, the Court clarified how this causative effect must be analyzed: the omitted or misstated fact must be undisputed or it must be determined by the trier of fact; the inference to which this fact would lead a reasonable shareholder must be found by the trier of fact, except in circumstances in which reasonable minds could not differ upon the inference to be drawn; finally, the significance of this inference to a reasonable shareholder in deciding how to vote must

118. *Id.* at 460.

119. See text accompanying note 70 *supra*.

120. 426 U.S. at 462.

121. *Id.* at 462-63.

be found by the trier of fact unless the information is "obviously important."¹²²

The three-step scheme for determining materiality is extrapolated from the opinion only with difficulty—although it is consistently applied—and it contains two ambiguities or inconsistencies that must be explained. First, the Court's treatment of the middle step in the analysis of materiality (the determination of the inferences to be drawn from a fact omitted or misstated in a proxy statement) is susceptible of two different interpretations. Early in the opinion the Court stated that the second step in the determination of materiality is a factual determination of the inferences that would be drawn by a reasonable shareholder from the underlying facts alleged to be misstated or omitted in the proxy statement.¹²³ This language indicates that the trier of fact is to determine the inferences a reasonable shareholder would draw based upon the information that would have been available *at the time of the proxy statement* had the misstatement or omission not occurred. For example, if the purchases of stock by National and Madison are the omitted facts, the question presented to the trier of fact is whether a reasonable shareholder would have inferred market manipulation from these facts. The factual determination of whether the inference of manipulation would have been drawn by a reasonable shareholder would be made under the assumption that the reasonable shareholder had access to the information in the proxy statement plus the omitted information concerning the purchases by National and Madison.

In discussing the omissions from the proxy statement relating to the control and manipulation issues, however, the Court seems to refer to a determination by the trier of fact based upon the facts *available at trial*,¹²⁴ not upon the facts available at the time of the proxy solicitation; that is, the Court appears to be requiring proof of the truth of the inference made from the information omitted from the proxy statement, rather than proof that a reasonable shareholder would have made the inference. For example, in discussing the manipulation issue the Court states: "[I]f liability is to be imposed in this case upon a theory that it was misleading to fail to disclose purchases suggestive of market manipulation, there must be some showing that there was in fact market manipulation."¹²⁵ This can be interpreted to mean that the Court is requiring proof at trial that there was actual market manipulation by TSC and National, not proof that a reasonable shareholder would have inferred manipulation from the information available to him at the date of the proxy solicitation.

122. See text accompanying notes 97-102 *supra*.

123. 426 U.S. at 450.

124. *Id.* at 453, 462-63.

125. *Id.* at 463.

Thus, it is completely unclear from the Court's opinion which type of factual determination comprises the second step of the materiality analysis. There is language supporting both interpretations. The language supporting the first interpretation, that the trier of fact must decide what inference would be drawn by a reasonable shareholder at the time the proxy statement was issued, is found in the Court's opening statements and in a footnote that is dictum.¹²⁶ The Court's discussion of the specific omissions in the case, however, indicates that the trier of fact must determine whether the state of facts to be inferred from the information misstated or omitted in the proxy statement actually existed.¹²⁷ If the Court intends to require actual proof of the second inference between the misstated or omitted fact and the determination of its significance to a reasonable shareholder's voting decision, the Court appears to be placing a formidable barrier in the way of recovery under the proxy rules. This conclusion leads to a consideration of the other apparent inconsistency in the opinion.

The Court assigns to some facts a neutral value, not allowing them to serve as a basis for a finding of materiality—even though those facts are undisputed—unless they lead to an intermediate inference.¹²⁸ Examples of these neutral facts in *TSC* are the information contained in the SEC filings, Yarmouth's and Simonelli's positions on the TSC board, and the purchases by National and Madison of National common stock. Examples of the intermediate inferences required by the Court before a neutral fact may be the basis for a determination of materiality are National's control of TSC and market manipulation by National and Madison. If the Court is treating these intermediate inferences as facts which must be proved at trial,¹²⁹ an ambiguity becomes apparent. The Court is willing to allow these inferences, once they have become facts proved at trial, to be a basis for the determination of materiality without interposing a middle step in the analysis. The Court is differentiating between two types of facts, one of which can lead directly to a determination of significance to the reasonable shareholder while the other cannot. The distinction between the two types of facts drawn by the Court appears to be an arbitrary one. A reason for the distinction can be found, however, if the policy judgment forming the basis for the Court's theoretical scheme for determining materiality is explored.

B. *The Policy Behind TSC*

The Court's underlying concern in *TSC* was that the concept of

126. *Id.* at 450, 453-54 n.15.

127. *Id.* at 453, 462-63.

128. See text accompanying notes 97-102 *supra*.

129. See text accompanying notes 123-27 *supra*.

materiality, and thus the danger of liability, was being broadened through the use of the "might" standard by the lower courts.¹³⁰

The potential liability for a Rule 14a-9 violation can be great indeed, and if the standard of materiality is unnecessarily low, not only may the corporation and its management be subjected to liability for insignificant omissions or misstatements, but also management's fear of exposing itself to substantial liability may cause it simply to bury the shareholder in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking. Precisely these dangers are presented, we think, by the definition of a material fact adopted by the Court of Appeals in this case. . . .¹³¹

The Court was not alone in perceiving this danger. One writer, commenting on the Seventh Circuit's *TSC* decision, noted that the case stood for an extraordinarily low threshold of liability and wondered if the "reasonable stockholder" who provides the only safety valve in [*TSC*'s] 'might have been' test might (or would) not become 'unreasonable.'¹³²

Even a few lower courts had become aware that the language used by the Court in *Mills* and *Affiliated Ute* could be utilized by a court to grant relief for minor defects in disclosure.

While these verbal formulations by the courts and the SEC taken individually fail to prescribe a precise standard, they do evince a trend toward broadening the definition of materiality and concomitantly raising the requirement of disclosure where the law requires full disclosure.¹³³

The breadth of the "might" standard caused at least two circuits to reject the standard before the Supreme Court did so in *TSC*. In *Gerstle v. Gamble-Skogmo, Inc.* the Second Circuit pointed out that *Mills* and *Affiliated Ute* dealt with reliance and stated that,

[w]hile the difference between "might" and "would" may seem gossamer, the former is too suggestive of mere possibility, however unlikely. When account is taken of the heavy damages that may be imposed, a standard tending toward probability rather than toward mere possibility is more appropriate.¹³⁴

The Fifth Circuit, in *Smallwood v. Pearl Brewing Co.*, refused to "relax the standard of materiality to a mere possibility of influence upon a reasonable investor, a standard implied by the word 'might,'" and noted that the Supreme Court had not considered the ramifications of its language in *Mills* and *Affiliated Ute*.¹³⁵

130. 426 U.S. at 448-49.

131. *Id.*

132. Kirkland, *Misleading Proxy Statements—The Seventh Circuit Strengthens the Minority Stockholder's Rule 14a-9 Action: Northway v. TSC Industries*, 512 F.2d 324 (7th Cir. 1975), 31 BUS. LAW. 1449, 1457 (1976).

133. *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 571 (E.D.N.Y. 1971).

134. 478 F.2d 1281, 1302 (2d Cir. 1973).

135. 489 F.2d 579, 604 (5th Cir. 1974).

Several courts had used the "would" and "might" standards interchangeably or had stated that there was no difference between the two.¹³⁶ Courts that applied the "might" test of materiality generally arrived at results that could also have been reached under the "would" test articulated in *TSC*.¹³⁷ However, in at least two district court cases a plaintiff's motion for summary judgment was granted in situations in which the Supreme Court's three-step materiality analysis would likely have produced different results.¹³⁸

In deciding *TSC* the Supreme Court may have been concerned about the broadening of the materiality standard for a very specific reason. The use of the "might" standard by the lower courts may have been perceived by the Court as an indication that the federal courts were becoming too involved in the supervision of corporate behavior, an area traditionally governed by state corporation law. This type of extension of the federal securities laws to reach behavior other than faulty disclosure has been widely noted.¹³⁹

The disclosure requirements of the SEC rules are susceptible to use by plaintiffs who have no interest in more complete disclosure but who wish to gain relief for some corporate transaction that has caused them injury. For example, the plaintiff in *TSC* may have been concerned about the possible unfairness of the merger transaction between *TSC* and National. It may have tried to use the disclosure requirements of the proxy rules to attack the merger indirectly because, for one reason or another, the outcome of a direct attack on the merger under state corporation law was uncertain. An example of this strategy is presented by a recent decision involving Northrop Corporation, in which a proxy rule violation was used to force settlement of a claim relating to illegal campaign contributions.¹⁴⁰ The plaintiffs in that

136. *E.g.*, *Jansky v. Miller*, 474 F.2d 365, 367-68 (9th Cir. 1973); *Ross v. Longchamps Inc.*, 336 F. Supp. 434, 441 (E.D. Mo. 1971); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 571 (E.D.N.Y. 1971).

137. *See, e.g.*, *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846 (3d Cir. 1973); *Commonwealth Oil Ref. Co. v. Tesoro Petroleum Corp.*, 394 F. Supp. 267 (S.D.N.Y. 1975); *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974); *Kaufmann v. Lawrence*, 386 F. Supp. 12 (S.D.N.Y. 1974); *Puma v. Marriott*, 363 F. Supp. 750 (D. Del. 1973); *Allen v. Penn Central Co.*, 350 F. Supp. 697 (E.D. Pa. 1972); *First Sur. Corp. v. Community Bank*, 337 F. Supp. 667 (C.D. Cal. 1971); *Dillon v. Berg*, 326 F. Supp. 1214 (D. Del.), *aff'd*, 453 F.2d 876 (3d Cir. 1971).

138. *See Beatty v. Bright*, 318 F. Supp. 169 (S.D. Iowa 1970); *Colonial Realty Corp. v. Baldwin-Montrose Chem. Co.*, 312 F. Supp. 1296 (E.D. Pa. 1970). *See also Sonesta Int'l Hotels Corp. v. Wellington Assocs.*, 483 F.2d 247 (2d Cir. 1973), in which the Second Circuit, which had applied the "would" standard in *Gersile* a few weeks earlier, suddenly applied the "might" standard.

139. *See notes 16 and 18 supra*; *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961); Kaplan, *Corporation Law and Securities Regulation*, 18 BUS. LAW. 868 (1963); Leavell, *Investment Advice and the Fraud Rules*, 65 MICH. L. REV. 1569 (1967); Ruder, *Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5*, 59 NW. U.L. REV. 185 (1964).

140. *Springer v. Jones*, Civ. No. 74-1455-G, (C.D. Cal. 1975) stipulation and order re: settlement.

case were concerned about the campaign contributions, not the disclosure methods used by Northrop, but the disclosure requirements of the proxy rules provided a convenient method of gaining relief indirectly.

More specifically, the disclosure requirements of the SEC rules are susceptible to use by plaintiffs desiring to attack corporate actions that cannot be reached under state law. For example, Northway might have known that it could not prove that TSC's management had inadequately protected the TSC shareholders in its negotiations with National; therefore, a breach of fiduciary duty could not be proved, and relief in state court would not have been granted. Yet the federal disclosure requirements provided a means to attack the behavior of the TSC management indirectly without the difficult proof required in state court.

Two possible interpretations of the Court's opinion in *TSC* have been suggested here with regard to the Court's ambiguous treatment of the second step in its three-step analysis of materiality. The Court required the determination of the inferences drawn from a fact omitted or misstated in a proxy statement to be made in one of two ways: 1) The trier of fact must decide what inferences a reasonable shareholder would have drawn based upon the information that would have been available at the time of the proxy statement, had the misstatement or omission not occurred; or, 2) The trier of fact must make a determination of the truth of the inference based upon the facts available at trial. Under the latter interpretation the Court is requiring proof that the middle inference had an actual basis in fact and was not merely one that would be drawn by a reasonable shareholder.¹⁴¹

If the Supreme Court's opinion is read as requiring proof that the state of affairs to be inferred from the omitted information in a proxy statement actually existed, the Court's purpose in differentiating between neutral facts that cannot lead independently to a determination of materiality (such as Yarmouth's and Simonelli's positions on the TSC board) and nonneutral facts that can lead to a determination of materiality (such as manipulation and control)¹⁴² may have been to ensure that plaintiffs do not use the federal courts to obtain relief that would be denied in state court. The Court, by requiring this proof of the middle inference in the materiality analysis, was requiring the very type of proof that Northway may have sought to avoid by bringing its action in federal rather than state court—*e.g.*, proof that National controlled TSC and therefore sat on both sides of the bargaining table.¹⁴³

141. See text accompanying notes 123-27 *supra*.

142. See text accompanying notes 128-29 *supra*.

143. 426 U.S. at 452.

By requiring proof of the nonneutral facts that serve as a basis for a determination of materiality, the Court has tied the disclosure requirements of the proxy rules to the type of behavior that is not disclosed or that is inaccurately disclosed. It is submitted that the Court distinguishes between neutral and nonneutral facts on the basis of what behavior would trigger liability under state corporation law —e.g., breach of fiduciary duty by the management of TSC. By inserting this middle step in the determination of materiality, the Court has placed a buffer between corporate nondisclosure and liability that in effect requires plaintiffs to prove culpable behavior as well as nondisclosure; and by requiring proof of the type of behavior that would have to be proved in an action under state corporation laws, the Court may be effectively eliminating the plaintiff's advantage thought to be obtainable under the federal securities laws.¹⁴⁴

Thus, the Court has arguably inserted an element into a rule 14a-9 cause of action that has no basis in the rule or in section 14(a). Not only must the plaintiff prove that a material misstatement or omission has appeared in the defendant's proxy statement but also that the defendant has engaged in culpable conduct similar in nature to a violation of state law. The use of a narrow standard of materiality to limit the scope of rule 14a-9 would be more defensible had it not involved the judicial legislation engaged in by the Court in *TSC*.

The *TSC* decision indicates that the Supreme Court may be attempting to draw a more distinct line between the federal protection of investors, which is accomplished through disclosure requirements, and state supervision of the relative rights of the constituents of the corporate entity. Although this is not apparent from the *TSC* decision alone, there have been several recent Supreme Court decisions that may be viewed in conjunction with *TSC* as an attempt to limit federal securities regulation to securities and to leave corporation law to the states.¹⁴⁵

In *Blue Chip Stamps v. Manor Drug Stores* the Supreme Court affirmed the rule announced in *Birnbaum v. Newport Steel Corp.*¹⁴⁶ that a private damage action under rule 10b-5 can be brought only by purchasers and sellers of securities.¹⁴⁷ This rule had previously been

144. See notes 16-19 *supra* and accompanying text.

145. For a suggestion that the Supreme Court is attempting to limit the class of plaintiffs able to gain relief under the federal securities laws, see 10 GA. L. REV. 1059 (1976).

146. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

147. 421 U.S. 723, 754-55 (1975). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud.

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would

adopted by four circuits, but its limitations on standing to sue had been largely eliminated by means of various broad exceptions to the rule.¹⁴⁸ Furthermore, the Seventh Circuit had explicitly rejected the *Birnbaum* rule in *Eason v. General Motors Acceptance Corp.*¹⁴⁹ The Supreme Court was concerned about the huge class of plaintiffs to which the rule 10b-5 remedies were being made available. Consequently, it viewed the *Blue Chip Stamps* case as an opportunity to point out that effective remedies exist under state law for corporate mismanagement and for securities law violations.¹⁵⁰ As one commentator has noted: "One of the consequences of *Blue Chip Stamps v. Manor Drug Stores* . . . will be the slackening, at least temporarily, of these pressures to extend 10b-5 to cover situations that are more 'management-misbehavior' than 'market-manipulation' oriented."¹⁵¹

The Supreme Court has further limited the class of plaintiffs who may obtain relief under the federal securities laws in *Piper v. Chris-Craft Industries, Inc.*¹⁵² This complicated litigation concerned an attempt by Chris-Craft Industries to gain control of Piper Aircraft Corporation that was successfully repelled by the Piper family, Bangor Punta Corporation, and First Boston Corporation (Bangor Punta's underwriter). Chris-Craft brought suit under section 14(e) of the Securities Exchange Act of 1934,¹⁵³ which forbids material misstatements or omissions in connection with any tender offer, and under rule 10b-6,¹⁵⁴ which prohibits issuers whose stock is being distributed from manipulating its price by purchasing the stock or rights to purchase the stock.

Most relevant here is the Supreme Court's disposition of Chris-Craft's claim under section 14(e). The Court held that section 14(e) was intended to protect investors confronted with a tender offer by ensuring adequate disclosure; it was not intended to protect frustrated tender-offerors.¹⁵⁵ Although Chris-Craft owned 42% of the Piper stock,

operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1976).

148. See Kellogg, *The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b-5 is Involved*, 20 BUFFALO L. REV. 93, 94-96 (1970); 44 FORDHAM L. REV. 452, 454 (1975). The *Birnbaum* rule was adopted by the Third Circuit in *Landy v. Federal Deposit Ins. Corp.*, 486 F.2d 139, 156-57 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974); by the Fifth Circuit in *Sargent v. Genesco, Inc.*, 492 F.2d 750, 763-64 (5th Cir. 1974); by the Sixth Circuit in *Simmons v. Wolfson*, 428 F.2d 455, 456 (6th Cir.), *cert. denied*, 400 U.S. 999 (1970); by the Eighth Circuit in *City Nat'l. Bank v. Vanderboom*, 422 F.2d 221, 227-28 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

149. 490 F.2d 654, 661 (7th Cir. 1973), *cert. denied*, 416 U.S. 960 (1974).

150. 421 U.S. at 738 n.9.

151. Vagts, *The Governance of the Corporation: The Options Available and the Power to Prescribe*, 31 BUS. LAW. 929, 937 n.26 (1976).

152. 97 S. Ct. 926 (1977).

153. 15 U.S.C. § 78n(e) (1970).

154. 17 C.F.R. § 240.10b-6 (1976).

155. 97 S. Ct. at 946.

the Court stated that Chris-Craft had not sued as an injured shareholder but as a defeated tender-offeror.¹⁵⁶ The Court further noted that Chris-Craft had a possible remedy in state court for "interference with a prospective commercial advantage" and that this was a factor in determining that Chris-Craft had no remedy under section 14(e) as a defeated tender-offeror.¹⁵⁷

In *Ernst & Ernst v. Hochfelder* the Supreme Court once again reversed the Seventh Circuit and indicated that proof of some form of "intent to deceive, manipulate, or defraud" on the part of the defendant is necessary to impose civil liability in a private action under rule 10b-5.¹⁵⁸ The Court noted that a standard of negligence would "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts."¹⁵⁹ The Court then referred to its language in *Blue Chip Stamps* that expressed a similar fear of extending recovery under rule 10b-5 too broadly.¹⁶⁰ As one commentator has noted: "The Court's decision . . . seems to indicate a desire to restrict the remedies made available by the antifraud legislation that has, heretofore, been construed flexibly, and not restrictively or technically."¹⁶¹

That the *TSC* decision indicates the intent of the Supreme Court to limit the coverage of the federal securities laws is most directly supported by *Santa Fe Industries, Inc. v. Green*.¹⁶² In that case, Santa Fe Industries, Inc. obtained 100% ownership of Kirby Lumber Corp. pursuant to section 253 of the Delaware Corporation Law,¹⁶³ a "short-form" merger statute not requiring the consent of or advance notice to minority shareholders. Minority shareholders of Kirby were notified of the merger and given an information statement that disclosed all relevant information concerning the transaction the day after its consummation.¹⁶⁴ They chose to attack the merger in federal court under rule 10b-5 rather than to use their appraisal remedy in the Delaware Court of Chancery.¹⁶⁵ The plaintiffs advanced two arguments in support of their claim that defendant Santa Fe had used a device to defraud them in violation of rule 10b-5(a): 1) the merger lacked a business purpose and was undertaken without prior notice to the minority

156. *Id.* at 946-47.

157. *Id.* at 949.

158. 425 U.S. 185, 214 (1976).

159. *Id.* at 214 n.33.

160. *Id.* at 214-15 n.33.

161. Murdock, *Birnbaum Revitalized: New Life for Motions to Dismiss in 10b-5 Actions for Damages*, 1975 UTAH L. REV. 663, 686.

162. 97 S.Ct. 1292 (1977).

163. DEL. CODE tit. 8, § 253 (1975).

164. 97 S.Ct. at 1297.

165. DEL. CODE tit. 8, § 262 (1975).

shareholders; 2) the value placed on the shares held by the minority shareholders was fraudulently low.¹⁶⁶

While the district court dismissed the complaint for failure to state a claim,¹⁶⁷ the Second Circuit reversed and stated that rule 10b-5 reaches "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure."¹⁶⁸ Therefore, the Second Circuit reasoned, allegations that the merger had no business purpose and was undertaken without notification to the minority shareholders constituted a proper basis for a claim under rule 10b-5(a).¹⁶⁹

The Supreme Court reversed the Second Circuit, stating that a breach of fiduciary duty is not encompassed by the terms "manipulative or deceptive" as those terms are used in section 10(b) of the 1934 Act.¹⁷⁰ Furthermore, the Supreme Court rejected the minority shareholders' claim that the failure to give advance notice of the merger was a material nondisclosure in violation of rule 10b-5(b).¹⁷¹ The Court stated that Delaware law does not require prior notification, and that notification would have been no help to the minority shareholders since their sole remedy under Delaware law for the alleged unfairness of a merger was an appraisal proceeding in the Delaware Court of Chancery. "Thus the failure to give advance notice was not a material nondisclosure within the meaning of the statute or the Rule."¹⁷² The Court in *Santa Fe* appears to be saying that the nondisclosure was not material because it was not a violation of state law. The opinion contains a lengthy discussion of the necessity of separating federal securities law from the state regulation of internal corporate matters.

Absent a clear indication of Congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.¹⁷³

166. 97 S. Ct. at 1298.

167. 391 F. Supp. 849 (S.D.N.Y. 1975).

168. 533 F.2d 1283, 1287 (2d Cir. 1976).

169. *Id.* at 1291.

170. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970), provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.

171. 97 S.Ct. at 1301-02.

172. 97 S.Ct. at 1301 n.14.

173. *Id.* at 1303-04. For further recent cases in which the Supreme Court has shown a

It is noteworthy in this regard that the Court makes specific reference to *TSC*.¹⁷⁴ Thus, the *TSC* decision indicates that the Supreme Court may wish to impose limitations upon a 14a-9 action similar to those it has imposed in the 10b-5 area.¹⁷⁵

V. CONCLUSION

The *TSC* decision ended a controversy spawned by the Supreme Court over the legal definition of materiality. The *Mills* and *Affiliated Ute* decisions had been interpreted by several courts to mean that the Supreme Court was adopting the "might" standard of materiality. The Court dispelled this notion in *TSC* by holding that the materiality of a statement or omission in a proxy statement is to be determined on the basis of what a reasonable shareholder *would* consider important. Furthermore, the Court made clear that the "would" standard of materiality is an objective test of vote-causation that replaced the subjective test of vote-causation, reliance, eliminated in *Mills* as an element of a 14a-9 action.

The Supreme Court also intimated in *TSC* that the federal securities laws do not offer unlimited protection to shareholders. The opinion evidences a desire to limit the relief available under rule 14a-9 in order to leave the supervision of corporations to the states.

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tendency to defer to state policies in the regulation of corporations, see *Cort v. Ash*, 422 U.S. 66, 78, 84 (1975); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971).

174. 97 S. Ct. at 1301 n.14.

175. That the reasoning of *TSC* is applicable to 10b-5 cases in which materiality is an issue is illustrated by *S.D. Cohn & Co. v. Woolf*, 426 U.S. 944 (1976), in which a 10b-5 case was vacated and remanded by the Supreme Court for further consideration in light of *TSC*. The Fifth Circuit had indicated that the proper test of materiality was the "might" standard, citing *Affiliated Ute*. *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975). See also *Wheat v. Hall*, 535 F.2d 874 (5th Cir. 1976); *Goldsholl v. Shapiro*, 417 F. Supp. 1291 (S.D.N.Y. 1976); *S.E.C. v. Galaxy Foods, Inc.*, 417 F. Supp. 1225 (E.D.N.Y. 1976).